DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0360
Gross Income Tax
For The Tax Periods: 1987 through 1996

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ISSUES

I. **Gross Income Tax – Intangibles**

Authority: IC 26-1-1-201, 45 IAC 1-1-17, 45 IAC 1.1-2-10, 45 IAC 1-1-29, 45 IAC 1-1-49, 45 IAC 1-1-51, 45 IAC 1-1-118, 45 IAC 15-3-2, IRC §7701, *United Leaseshares v. Citizens Bank & Trust*, 470 N.E.2d 1383 (Ind. App. 1984), *First National Leasing and Financial Corp. v. Ind. Dept of State Revenue,* 598 N.E.2d 640 (Ind. Tax Ct. 1992).

The Taxpayer protests the assessment of gross income tax on lease and interest income.

II. **Gross Income Tax – Penalty**

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2(c).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer, incorporated and domiciled out-of-state, owns diesel trucks licensed and titled in Indiana. The vehicles are leased to an Indiana dealer, who in turn, leases the vehicles to the consumer. More facts will be supplied as necessary.

I. **Gross Income Tax**: **Intangibles**

DISCUSSION

Taxpayer is the owner of vehicles licensed and titled in Indiana. These vehicles are leased to an Indiana franchisee, who in turn leases the vehicles to the consumer. During the audit, Taxpayer was determined to be a non-filer for gross income tax. Audit concluded from Taxpayer's books

and records that Taxpayer has been receiving lease revenues from their Indiana franchisee for leases of vehicles. The audit included those lease receipts received from the Indiana franchisee in Taxpayer's Indiana gross income.

Gross income includes all income actually or constructively received. 45 IAC1-1-17. Lease income is considered an intangible for gross income tax purposes. Intangible means a personal property right, which exists only in connection to something else. 45 IAC 1-1-51. Generally, receipts derived from an intangible are included in gross income. *Id.* However, "[t]he Gross Income Tax Act *[IC 6-2.1]* exempts income from transactions in interstate commerce, but only to the extent that the State is prohibited from taxing such income by the Constitution of the United States. Therefore, not all receipts derived from interstate commerce are afforded this exemption…." 45 IAC 1-1-118. Indiana may tax the lease income if it forms an integral part of a trade or business regularly conducted at a business situs in Indiana. 45 IAC 1-1-51.

Business situs is created when possession and control of a property right have been localized in some business activity away from the owner's domicile. 45 IAC 1-1-49. Taxpayer maintains that even if the income is characterized as income from operating leases, its connection with Indiana is still insufficient to establish a business situs.

LEASE VERSES FINANCING ARRANGEMENT

Taxpayer contends the audit incorrectly characterized Taxpayer's contracts with the dealers as operating leases. Pursuant to 45 IAC 1.1-2-10 (formerly 45 IAC 1-1-29):

> (a) Except as provided in subsection (b), rental income derived from leasing real or personal property is taxable as a service under section 5 of this rule.
> (b) If the leasing agreement is a financing device for a sale of tangible personal property that is normally sold in the regular course of the taxpayer's retail business, the receipts from the contract are taxable as a retail sale.
> (c) The department will consider many factors in determining the intent of the parties, including the following;
>
> (1) Whether the lease payments are to be applied to an equity to be acquired by the lessee
> (2) Whether the lessee will acquire title to the goods upon the lessor's receipt of a stated amount of payments under the contract.
> (3) Whether the total lease payments for a relatively short period of use make up an inordinately large proportion of the total payment needed for the lessee to secure title.
> (4) Whether the lease payments exceed the current fair rental value of like goods.
> (5) Whether the lease contains an option to buy at a price nominal in comparison to the value of the property when the option may be exercised.
> (6) Whether a part of the lease payments is designated or recognizable as interest or its equivalent.

Taxpayer states regardless of the fact that they do not sell tangible personal property in the ordinary course of business, the above regulation applies in principle. Taxpayer offers a Terminal Rental Adjustment Clause (TRAC) in addition to the standard operating lease agreement. Although the Indiana Code does not define TRAC, I.R.C. §7701(2001) states:

> …
> (h) MOTOR VEHICLE OPERATING LEASES
>
> (1) IN GENERAL.- For purposes of this title, in the case of a qualified motor vehicle operation agreement which contains a terminal rental adjustment clause—
> (A) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and
> (B) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect…
>
> (3) TERMINAL RENTAL ADJUSTMENT CLAUSE DEFINED.—
> (A) IN GENERAL.—For purposes of this subsection, the term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

Taxpayer treats the contracts as operating leases for federal income tax purposes. The TRAC clause is simply an agreement between Taxpayer and dealer that the vehicle will be sold upon termination of the lease. Taxpayer and dealer both maintain the right to sell the vehicle to a third party at the end of the lease. Thus, Taxpayer fails to demonstrate that they sale tangible personal property in their normal course of business.

Taxpayer next argues that the lease is intended as security. They cite *United Leaseshares v. Citizens Bank & Trust*, 470 N.E.2d 1383 (Ind. App. 1984). In *United Leaseshares*, the court pointed to Uniform Commercial Code (IC 26-1-1-201) to determine whether a lease is intended as security.

IC 26-1-1-201(37) states:

> "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (IC 26-1-2-401) is limited in effect to a reservation of a security interest…
>
> Whether a transaction creates a lease or security interest is determined by the facts of each case. However, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee and:

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods;
(b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
(c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or
(d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that:

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than fair market value of the goods at the time the lease is entered into; (*emphasis added*)
(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods;
(c) the lessee has an option to renew the lease or to become the owner of the goods;
(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or
(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

IC 26-1-1-201(37)

The lease agreement states that either party (Taxpayer or dealer) may terminate the agreement with sixty days notice. Thus, the lessee may terminate the lease. As stated above, the TRAC supplement is an agreement between Taxpayer and dealer in addition to the lease agreement that the vehicle will be sold at the end of the lease, regardless of who purchases the vehicle. Taxpayer notes that if they sell the vehicle, dealer will be charged a 15% selling commission. Nevertheless, Taxpayer maintains the option. The lessee (dealer) is not required to renew the lease or become the owner of the vehicle. Although Taxpayer may receive 100% of the cost of the vehicle via the TRAC supplement, the original term of the lease is not necessarily equal to or greater than the remaining economic life of the goods. A security interest is not established merely if the present value of the consideration the lessee is obligated to pay the lessor for the right to possession of the vehicles is equal to or greater than the fair market value of the vehicles. Hence, the Taxpayer has not shown that the TRAC clause acts as a security interest.

OPERATING LEASE

Taxpayer argues that if the Department finds that the lease agreements should not be treated as financing arrangements, they still would not have business situs if treated as operating leases. 45 IAC 1-1-49(6) states that "business situs" may be established by: "[o]wnership, leasing, rental, or other operation of income-producing property (real or personal)." Here, Taxpayer owns and leases trucks to Indiana customers.

Taxpayer states that they merely maintain passive control over the vehicles. They cite *First National Leasing and Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992). In *First National Leasing*, the Indiana Tax Court held that the income earned by an out-of-state corporation from leasing train derailment equipment to its wholly owned out-of-state subsidiary, who in turn, independently located the equipment in Indiana was not derived from Indiana sources. They found that First National only maintained passive control of the equipment. The subsidiary did not make a lease payment to First National Leasing from Indiana.

Here, unlike *First National* where property was leased to an out-of-state subsidiary, Taxpayer is leasing to Indiana customers i.e., the dealers. Taxpayer receives rental income from tangible personal property leased to the Indiana customer. Although Taxpayer does not maintain office space, perform services, or retain inventory in Indiana and approves contracts out-of-state, Taxpayer does not show that control is merely passive. Pursuant to the lease agreement, Taxpayer's customers may not sell the vehicle (unless agree to TRAC) and sublease only upon written authorization from Taxpayer. The customer can only get insurance from companies authorized by the Taxpayer and the policy cannot be canceled or changed without Taxpayer's consent. Taxpayer is also authorized to take depreciation deductions and assumes recognition as the owner for federal tax purposes. Taxpayer's control of its Indiana vehicles is more than passive. Such property represents a business situs with Indiana.

We next must determine whether Taxpayer maintains tax situs. Taxpayer will be found to have tax situs if the intangible or income derived therefrom forms an integral part of the business conducted at the Indiana business situs. 45 IAC 1-1-51. Again, Taxpayer analogizes the situation here with *First National* and states that the mere ownership of leased property in Indiana is insufficient to subject the entire lease transaction to the gross income tax. Nevertheless, the facts in this case differ. As stated above, *First National* involved the leasing of equipment from an out-of-state company to its wholly owned out-of-state subsidiary. The court found that First National did not have a business situs. For Taxpayer's purposes, *First National* is inapposite. As stated above, Taxpayer maintains income producing property, which it maintains more than a passive control, in the state of Indiana.

The lease income in this case is an integral part of Taxpayer's business activity in Indiana. Here, Taxpayer's primary business is the leasing of vehicles and the income in question is directly connected with the leasing of the vehicles in Indiana. Therefore, Taxpayer's business activities fall within the ambit of 45 IAC 1-1-51.

FINDING

The Taxpayer's protest is respectfully denied.

II. **Tax Administration – Penalty**

DISCUSSION

IC 6-8.1-10-2.1(d) allows a penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Also, 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. The Department finds that the Taxpayers demonstrated reasonable cause for their failure to pay tax.

FINDING

The Taxpayers' protest of the penalty is sustained.

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